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R&R Weekly Column
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The Collapse of SVB Marks The Return of Financial Stability Concerns

At the end of last week, the Silicon Valley Bank (SVB) collapsed, just a few days after a much smaller lender, Silvergate, announced a plan to wind down its operations. The bank had USD 212bn in assets, a market valuation of around USD 16bn as recently as Wednesday last week, and a valuation of USD 44bn less than 18 months ago. At the end of December 2022, SVB had USD 173bn in deposits. However, on Thursday the bank suffered a USD 42bn withdrawal of deposits, after losing USD 1.8bn in a USD 21bn sale of part of its bond portfolio (made up of Treasuries and mortgage-backed securities).

SVB tried to make a final, desperate attempt to shore up its capital by issuing USD 1.25bn of its common stock, plus USD 0.5bn of mandatory convertible preferred shares (which are slightly less dilutive to existing shareholders), while private equity (PE) firm General Atlantic had previously agreed to buy 0.5bn of SBV's common stock in a separate private transaction. But this last attempt failed, and the bank was shut down by the Federal Deposit Insurance Corporation (FDIC), the US regulator that guarantees bank deposits of up to USD 250,000. Following that, the Bank of England put the UK arm of SVB into insolvency as well.

Why did the bank fail? Being exposed to crypto trading (Circle, the operator of one of the world's largest stablecoins, said that USD 3.3bn of its reserves were held at SVB) and start-ups, including in the healthcare sector, one could think that the bank failed given the collapse in tech and crypto assets valuations over the last year. But the reality is much simpler, and to a certain extent is even more alarming.

The business model of SVB was surprisingly "conservative". The bank would receive large deposits from tech and crypto companies that had raised their funds through venture capitalists and PE firms. These deposits were reinvested into ultra-safe bonds – in particular Treasuries and mortgage-backed securities, both of them held in massive quantities by the Federal Reserve – and also foreign government bonds. As of the end of 2022, the bank had $26.1bn in available-for-sale securities and around $91bn of securities in a held-to-maturity portfolio.

This business model would make money as long as policy interest rates were low, such that the cost of deposits would be minimal and the value of the bond portfolio would remain high. But as the Fed increased its policy rates by around 5% in one year, the cost of deposits rose from 0.14% to 2.33% in the same time-span, while the value of the bond portfolio declined. For this reason, the bank had reported a loss of USD 15bn at the end of last year.

So, the bank didn't fail because it had invested in assets that were too speculative, or followed a business model that was too risky. It collapsed because the most basic risk management practices were not followed. Banks tend to have a diversified depositor base, with a number of small – fully insured – depositors. They would not run at the first bad news. But the vast majority of SVB's depositors were not insured, so they wanted their money out as soon as they perceived an increased default risk. Furthermore, banks would normally invests in floating rate notes, which gain in value if interest rates go up, or they would enter into swap agreements to insure against rising interest rates. This didn't happen.

So, why this is scary? We discussed how recently the New York Fed had defined an r** rate, a rate over which financial stability episodes could emerge. If r** was below the neutral interest rate, r*, or in any case if it was below the terminal rate, the central bank may be forced to stop its tightening cycle in order to prevent further episodes from emerging So, as Hyman Minsky predicted in his Financial Instability Hypothesis, downturns in financial markets occur when interest rates go up. SVB was a fragile bank, from a Minskian perspective, for the reasons exposed above. But other lenders may fall from similar difficulties if interest rates continue to increase at this speed. And all this is happening just days before the next FOMC meeting, in which the Fed may decide to ratchet up the pace of its tightening cycle again, by 50bps, in response to the positive news from the labour market and the stubbornly high inflation rate.

Our Recent Publications

- *The UK-EU Windsor Framework: A New Deal for Northern Ireland, by London Politica, 10 March 2023*
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- *Syria's Post-Earthquake Diplomatic Standing In The Gulf, by Gulf State Analytics, 2 March 2023*

Looking Ahead

The Week Ahead: US Inflation To Fall; EZ Headline Inflation To Ease, While Core Rises; ECB To Increase Interest Rates

In the US, in February, both headline and core inflation are expected to fall to 6.0% y-o-y (*p:* 6.4%) and 5.5% y-o-y (*p:* 5.6%). In February, retail sales are likely to shrink by 0.3% m-o-m (*p:* 3.0%).

In the EZ, in February, headline inflation is seen decreasing to 8.5% y-o-y (*p:* 8.6%), while core inflation is seen edging up to 5.6% y-o-y (*p:* 5.3%). January, IP is seen recovering to 0.2% y-o-y (*p:* -1.7%).

Among the largest EZ economies, inflation rate is expected to: *i)* increase in France to 6.2% y-o-y (p: 6.0%); and *ii)* ease off in Italy to 9.2% y-o-y (p: 10.0%).

Still in the EZ, the ECB is expected to raise its main policy rate by 50bps, thus *i)* interest rate on the 'main refinancing operations' to 3.5%; *ii)* interest rate on the 'marginal lending facility' to 3.75%; and *iii)* 'deposit facility' to 3.0%.

In the UK, in January, the unemployment rate is likely to edge up to 3.8% (*p:* 3.7%).

The Quarter Ahead: SVB Collapses And Regulators Take Over; Li Qiang Becomes China's Premier; War In Ukraine

Silicon Valley Bank collapses after failing to raise capital. California regulator closed Silicon Valley Bank (SVB) and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver for later disposition of the assets. SVB collapsed suddenly, following 47 hours of bank run and capital crisis, leading to the second-largest failure of a financial institution in US history after Washington Mutual in 2008. SVB focused on lending to start-ups and tech companies. As a result, bank shares fell in the US and Europe.

Li Qiang becomes China's premier, replacing retiring Li Keqiang. As Xi Jinping is elected President of The Republic for the third time, Li Qiang, the former Communist Part chief of Shanghai, was behind the 2-month COVID-19 lockdown of Shanghai. Li Qiang was also president of Xi Jinping's chief of Staff in the early 2000s.

War in Ukraine. Nationwide outages continue after strikes. As Ukrainian Deputy Defence Minister reported that the fights in Bakhmut "escalated", as Russian forces renew their push. Meanwhile, Zelensky rejected Russian claims that Ukraine was behind Nord Stream's explosions that damaged gas pipelines running between Russia and Germany.

Last Week's Review

Real Economy: EZ QoQ GDP Stalled And YoY GDP Slowed Down; US Unemployment Rose And Non-Farm Payroll added 311K

In the US, In February, the unemployment rate increased to 3.6%. NFPs increased by 311K (*p:* 504K).

In the EZ, in Q4, GDP stalled on a quarterly basis (*p:* 0.3%) and decelerated to 1.8% y-o-y (*c:* 1.9%; *p:* 2.4%). In January, retail sales contracted by 2.3% y-o-y (*c:* -1.8%; *p*: -2.8%) and advanced by 0.3% m-o-m (*c:* 1.0%; *p*: -1.7%).

Among largest EZ economies, in February, in Germany, the inflation rate stood unchanged at 8.7% y-o-y as expected.

In the UK, in January IP shrank by 0.3% m-o-m (*c:* -0.1%; *p:* 0.3%) and 4.3% y-o-y (*c:* -4.0%; *p*: -4.0%).

Financial Markets: Stock Prices, the Dollar, Oil prices and Bond Yields Fell, while Gold Prices Edged Up On a Weekly Basis

Market Drivers: Investors worried about rate hikes. Over the renewed hawkishness from Powell, stocks pulled back. Concerns rose also due to the collapse of SVB Financial. As a result, treasury yields plunged, with the 2Y UST yield posting its biggest 2-day drop since 2008, as investors sought safety after the shutdown of SVB.

Global Equities: Decreased *w-o-w* (MSCI ACWI, -3.6%, to 616.60). The US S&P 500 index edged down (-4.5% w-o-w, to 3,861.59). In the EZ, share prices were down (Eurostoxx 50, -1.5% w-o-w, to 4,229.53). In EMs, equity prices moved down (MSCI EMs, -3.3%, to 955.28). Volatility rose to 23.85 (VIX S&P 500, 52w avg.: 26.1; 10y avg.: 18.5).

Fixed Income: *w-o-w*, the 10-year US treasury yields were down (-25 bps to 3.70%). The 2-year US Treasury yields fell (-27 bps to 4.59%). The German 10-year bund yield decreased (-25 bps to 2.46%).

FX: *w-o-w,* the US Dollar Index decreased (DXY, +0.1%, to 104.6; EUR/USD +0.1%, to 1.06). In EMs, currencies fell (MSCI EM Currency Index, -0.5% w-o-w, to 1,666.38).

Commodities: *w-o-w,* oil prices decreased (Brent, -3.7% to 82.64 USD/b). Gold prices rose w-o-w (+1.0% to 1,872.70 USD/Oz).

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*